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## **2005 ANNUAL REPORT OF THE CHIEF COMPLIANCE OFFICER January 1, 2005 - December 31, 2005**

Compliance programs have traditionally been structured around the minimum requirements established by the U.S. Sentencing Commission's "Organizational Sentencing Guidelines" as the hallmarks of an effective compliance and ethics program. Under the guidelines, an effective program is maintained to: exercise due diligence to prevent and detect criminal conduct; and promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.

This report is intended to provide a summary review of compliance program accomplishments and goals to assist business lines and divisions in their compliance planning efforts for the next year.

This is the first Annual Report of the Chief Compliance Officer of the California Public Employees' Retirement System and provides information on 2005 accomplishments and the goals for the upcoming calendar year of 2006.

### **I. STRUCTURE AND STAFFING OF THE OFFICE OF ENTERPRISE COMPLIANCE**

The Chief Compliance Officer was appointed on December 9, 2004. The Division of the Office of Enterprise Compliance was established on March 22, 2005. The Chief Compliance Officer reports administratively to the General Counsel and directly to the Chief Executive Officer and to the Chairman of the Board of Administration's Finance Committee.

The Chief Compliance Officer presents an oral and written report of Office of Enterprise Compliance activities to the Finance Committee at all committee meetings and has reported on seven occasions during 2005. It should be noted that it is considered a best practice for the Chief Compliance Officer to make annual or quarterly reports to their board members.

Consistent with the new amendments of the guidelines, a greater emphasis is being placed on the importance of adequate resources and authority for

individuals with the responsibility for implementing a compliance and ethics program. In response to that greater emphasis:

The Compliance Area Manager for Investments position was established and filled on July 25, 2005. The position was filled with an Investment Officer I classification.

An Executive Secretary I position was established in May 2005 and recruitment efforts took place for seven months. Due to the challenges of recruitment and selection for this candidate pool, the position remains vacant and recruitment is currently ongoing in 2006.

The position for the Compliance Area Manager for Health was established in December 2005. Recruitment for this position is occurring in January 2006.

Budget authority was requested and approved to create a Compliance Area Manager for Pension and Retirement in the fiscal year 2006-07.

The operating budget established for the Office of Enterprise Compliance consisted of an annual operating budget of \$446,773 and 4 positions. The 2006 operating budget reflects an increase in staffing due to change in operating conditions.

## **II. OFFICE OF ENTERPRISE COMPLIANCE 2005 ACCOMPLISHMENTS**

### **Mission**

The mission of the Office of Enterprise Compliance is to ensure, promote and support an organizational culture which builds compliance awareness into the daily business processes for Investments, Health and Retirement. The Chief Compliance Officer will accomplish this mission by monitoring CalPERS business activities, policies and procedures and by establishing an infrastructure that provides assurance to management that program areas comply with all applicable laws, regulations, policies and best practices.

### **Program Management**

- In December 2003, Finance Committee directed staff to develop a plan to establish a formal compliance effort at CalPERS. As outlined in April 2004 "Enterprise Compliance Concept Paper," the Chief Compliance Officer (CCO) position was created and resourced. The CCO was appointed in December 2004.
- CCO successfully integrated objectives, opportunities and resources to create an interdisciplinary team with subject matter expertise to develop three year

work plan, compliance model, team charter, mission, roles and responsibilities.

- In addition to initiating the three year plan for Enterprise Compliance, the CCO built the foundation for the new division for CalPERS, Office of Enterprise Compliance. This includes; Delegation of Authority for Chief Compliance Officer, future budget requests, budget allocation and expenditure management, staffing plan, duty statements, space and equipment. CCO demonstrated leadership for the expanding division by developing future organizational growth and succession strategies for the division. The Office of Enterprise Compliance is expanding by two staff this year and will be actively recruiting a diverse and qualified workforce. The division will continue to expand as each project phase is completed.

### **Communication Strategy**

- The Finance Committee provided direction to the CCO to communicate and network with other state pension plans and provide examples of “best practices” to be shared. The CCO conducted compliance benchmarking review with Pension Consultant Chief Compliance Officer and three other state pension plans. An ongoing network continues with other Compliance Officers, sharing best practices. The “CalPERS Enterprise Compliance Concept Paper” has been provided to ten other state pension funds.
- In an effort to network and communicate with external audiences, “The Journey of Compliance at CalPERS” presentation was provided to the CalPERS’ Board of Administration, National Association of Public Pension Attorneys, and Texas Teachers Retirement Compliance Office.
- The division launched the internal compliance education, communication and awareness efforts which include: implement communication strategy for announcing the new division, “Announcement from CEO,” “Executive Sponsorship Invitation,” newsletter articles in the Member Update, and CalPERS Perspective and on-line employee newsletter.
- CCO also prepared and presented “Enterprise Compliance Executive Advisor” presentation to Assistant Executive Officers and designated Division Chiefs to introduce program and to solicit support and participation on project team.
- In response to Assistant Executive Officer requests, CCO presented Enterprise Compliance Presentation to CalPERS Actuarial and Employer Services Branch All-Staff Meeting and Member and Benefit Services Branch management meeting, all Legal staff and all Fiscal Services Staff.

### **Investment Compliance**

- The first phase of Enterprise Compliance implemented in 2005 was Investments. A subject matter expert was identified in Investments to work

with the division and a Compliance Area Manager of Investments position was created and staffed.

- At General Counsel and Chief Executive Officer requests, CCO consulted and conducted a review of investment proxy voting guidelines, policies and procedures. The review included analysis of past practices, issues and current industry “best practices.” CCO provided specific recommendations for process improvement to Investment Office management on proxy voting guidelines and process.
- At the request of the Assistant Executive Investment Officer, reviewed and participated in transition of Charles River Portfolio Management Compliance Module; including development of protocol and procedures for monitoring, resolving and reporting investment trading alerts. This transition represents a significant shift of daily compliance activities. This monitoring, resolving and reporting of alerts and warnings is now performed by Compliance personnel.
- The Finance Committee requested a quarterly update from the Office of Enterprise Compliance on new or changes to regulations that may impact CalPERS. CCO conducted research of industry best practices to purchase and implement industry regulatory compliance monitoring tool, “Compliance Ease.” “Compliance Ease” provides sample policy, procedures, guides and weekly updates of new or revised regulations or changes in the industry.

### **III. EDUCATION AND TRAINING**

- As required under U. S. Sentencing Guidelines and California Assembly Bill 1825, all CalPERS employees have received Sexual Harassment Prevention training.
- Designated employees and Board members have received ethics training. Training records are maintained and monitored with state and federal requirements.
- In response to the new requirement that an effective compliance and ethics program shall promote an “organizational culture that encourages ethical conduct and a commitment to compliance with the law,” Compliance Education and Awareness Presentations were given to seven divisions in 2005. This represents 50% of divisions who have attended or participated in a compliance information event.
- The guidelines also emphasize an organization should take reasonable steps to communicate periodically and in a practical manner its standards and procedures and other aspects of the compliance and ethics program, to members of the governing authority, high-level personnel, employees and agents of the organization by conducting training and disseminating information. In meeting this requirement the following education and

communication actions were taken; compliance presentations were given to staff, articles were published in both the "Update" and the "Perspective" regarding Enterprise Compliance responsibility and the internal and external Office of Enterprise Compliance website was launched in December 2005.

- In conformance with the new guidelines requirement to provide "appropriate incentives" to perform in accordance with the compliance program a strategy was created to increase enterprise compliance awareness and integration of compliance activities into each division. Each division chief is required to develop their annual objectives to conduct policy review and identify rules and regulations for their business line. Each division should also identify any current tools or methods used to ensure operational compliance with laws and rules. Each division chief should also report the number of employees who have had ethics training and that all new employees are familiar with relevant policies for their position.

#### **IV. INVESTMENTS BUSINESS LINE**

The requirements also are explicit and state that the new requirements include a periodic evaluation of the effectiveness of the program. As the Investments Business line is the first phase of the implementation plan, the following activities have been conducted in the area of Investments in review of compliance activities and duties in Investment operations.

- The organization has existing policy in the areas of Insider Trading, Conflict of Interest and Incompatible Interest Activities statement and the Fraud, Criminal Acts and Investigation Policy.
- In the first quarter of 2005, Chief Compliance Officer completed a review of proxy voting procedures and made recommendations to Investment office staff.
- Securities lending operations are scheduled for review in 2006.
- Compliance personnel participated in review of Global Equity portfolio management system and are monitoring system daily and providing weekly reporting.
- Compliance personnel participated in review of Fixed Income portfolio management system and are monitoring system daily and providing weekly reporting.
- Compliance personnel have met with Real Estate Investment management and have discussed policy and procedures.

- Compliance personnel have met with AIM Investment management and have discussed policy and procedures.
- Derivatives operations are scheduled for review in 2006.

#### **Activities and Goals for the Upcoming Year**

- Transition Fixed Income Portfolio Management Compliance duties to Office of Enterprise Compliance. (First Quarter)
- Monitoring and reporting of Fixed Income compliance violations. (Ongoing)
- Submit Personal Trading Policy to Investment Policy sub-committee. (First Quarter)
- Monitoring and reporting of Global Equity compliance violations. (Ongoing)
- Review policies and procedures for Real Estate Compliance. Identify areas of highest risk, review specific procedures, and monitor for compliance. (Second Quarter)
- Review policies and procedures for Alternative Investment Management strategies. Identify areas of highest risk, review specific procedures, and monitor for compliance. (Second Quarter)
- Review policies and procedures for Derivatives. Identify areas of highest risk, review specific procedures, and monitor for compliance. (Fourth Quarter)
- Conduct follow up review of proxy voting recommendations implementation. (Third Quarter)
- Develop Compliance Manual for Investments Compliance Area Manager. (Fourth Quarter)

### **V. HEALTH BUSINESS LINE**

#### **Activities and Goals for the Upcoming Year**

- Present Compliance Presentation to Health Benefits All Staff. (First Quarter)
- Recruit and hire Compliance Area Manager for Health. (First Quarter)
- Review HIPAA Compliance with Audits. (First Quarter)

- Research related regulation, laws and rules for Health Compliance (First and Second Quarter)
- Attend Health Compliance Workshops and Conferences to have access to “best practices” and tools in Health Compliance. (Ongoing)
- Continue to build Health Regulatory Matrix in collaboration with Health Business Line. (Third Quarter)
- Review existing policies in compliance with applicable laws and rules for Health Business Line. (Ongoing)
- Create monitoring and reporting tools for Health Compliance and the Health Benefits Committee. (Ongoing)

## **VI. PENSION BUSINESS LINE**

### **Activities and Goals for the Upcoming Year**

- Develop duty statement for Compliance Area Manager for Pension Business line. (Third Quarter)
- Recruit and hire Compliance Area Manager for Pension Business line in 2006-07. (Fourth Quarter)
- Present Compliance Presentation to Pension Business Line Staff. (Ongoing)
- Review previous audit reports of Pension Business Line. (Third Quarter)
- Research related regulation, laws and rules for Pension Compliance. (Ongoing)
- Attend Pension and Retirement Compliance Workshops and Conferences to have access to “best practices” and tools in Pension Compliance. (Ongoing)
- Continue to build Pension Retirement Regulatory Matrix in collaboration with Pension Business Line. (Fourth Quarter)
- Review existing policies in compliance with applicable laws and rules for Pension Business Line. (Ongoing)
- Create monitoring and reporting tools for Pension and Retirement Compliance for the Benefits and Program Administration Committee. (Ongoing)

## **VII. ENTERPRISE BUSINESS LINE**

The new requirements also require an organization to have a system whereby the organization's employees and agents can "seek guidance" regarding potential or actual violations of law. It also has an explicit requirement for the reporting mechanism to allow for anonymous reporting. Currently as a governmental entity the organization meets this requirement in multiple administrative processes. First, the Bureau of State Audits administers the State of California "Whistleblower Hotline" that can be used for State employees and others to report illegal acts, theft, fraud, or conflicts of interest by state employees. Second, the organization has internal complaint processes in both the Office of Audit Services and the Equal Employment Officer. Employees have additional protection against retaliation through complaint processes with the State Personnel Board, the Department of Fair Employment and Housing, and the federal Equal Employment Opportunity Commission.

The requirements also outline that an explicit requirement is that organizations should conduct periodic risk assessment and that the governing authority shall be knowledgeable about the content and exercise reasonable oversight with respect to the program. In June 2005, the Office of Audit Services conducted enterprise-wide risk assessment and audit coverage of public contracting agencies, internal operations, and third-party administrators acting on the organization's behalf.

### **Activities and Goals for the Upcoming Year**

- In collaboration with Audits, create an enterprise-wide Risk Committee. (Fourth Quarter)
- In collaboration with Audits, develop internal hotline for complaints. Include issue escalation and resolution plan. (Fourth Quarter)
- Develop Proposal for Business Planning Cycle to provide additional Compliance staff for infrastructure compliance monitoring and administrative support unit. (Fourth Quarter)
- Prepare plan to conduct Compliance Reviews of remaining enterprise Business Lines. (Fourth Quarter)